

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

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PLR-115345-20

Date:

December 15, 2020

Legend

Taxpayer =

Country A =

Foreign Entity A =

Foreign Entity B =

Foreign Entity C =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

Month 1 =

Dear :

This responds to correspondence dated July 7, 2020 and December 9, 2020, submitted by your representatives. The correspondence requests that the Internal Revenue Service ("Service") grant Taxpayer consent to use the methods described in Treas. Reg. § 1.482-7(d)(3)(iii)(B) and Notice 2005-99, 2005-2 C.B. 1214, for measuring, timing, and identifying employee stock options, restricted shares, restricted share units, and stock appreciation rights as related to intangible development activity ("IDA") for purposes of determining the amount Taxpayer must include in its cost sharing arrangement ("CSA") as intangible development costs ("IDCs") for Year 4 and subsequent tax years.

The consent granted by this letter is based on facts and representations submitted by Taxpayer and its representatives and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data may be required as part of the audit process.

FACTS

Taxpayer, a domestic corporation, was incorporated in Year 1. Effective Date 1, Taxpayer and Foreign Entity A entered into an agreement that they intended would qualify as a CSA within the meaning of Treas. Reg. § 1.482-7(b). Taxpayer has subsequently restructured its operations a number of times since Date 1. At the time of Taxpayer's submission of this request, Foreign Entity B and Foreign Entity C had replaced Foreign Entity A as controlled participants in the CSA.

Since Year 2, Taxpayer has followed a stock-based compensation ("SBC") plan, pursuant to which it issues equity awards with respect to shares of Taxpayer's common stock to its employees and employees of its affiliates. In Month 1, Taxpayer closed its initial public offering and became publicly traded on an established U.S. securities market.

For certain years prior to Year 3, Taxpayer and the foreign controlled participant(s) under the CSA did not include SBC as IDCs under the CSA. Beginning in Year 3, however, Taxpayer and the foreign controlled participant(s) under the CSA have included SBC as IDCs, using the method for measurement and timing of SBC provided in Treas. Reg. § 1.482-7(d)(3)(iii)(A) (the "default method") and the method for identifying SBC as related to IDA provided in Treas. Reg. § 1.482-7(d)(3)(ii) ("grant-date identification"). Taxpayer has stated that it will correct any and all noncompliance with Treas. Reg. § 1.482-7(d)(1)(iii) (i.e., failing to include SBC as IDCs) for all years prior to Year 3.

Taxpayer filed this request for the Commissioner's consent to prospectively change its method for measurement and timing for purposes of taking into account SBC that Taxpayer must include as IDCs from the default method to the method described in Treas. Reg. § 1.482-7(d)(3)(iii)(B), which was extended to certain restricted shares and restricted share units by Notice 2005-99 ("elective method"). Taxpayer also requested consent to prospectively change its method for identifying SBC with the IDA from grant date identification as provided in Treas. Reg. § 1.482-7(d)(3)(ii) to period-by-period identification as provided in Notice 2005-99.

Taxpayer has made the following representations, as stated in its submissions:

- 1) With regard to its CSA, Taxpayer will remain in compliance with all record-keeping requirements of the Internal Revenue Code of 1986, as amended, and

the regulations thereunder, including Treas. Reg. § 1.482-7(k)(2)(ii). Upon request, Taxpayer will timely provide to the Commissioner records kept pursuant to such requirements.

- 2) The SBC for which Taxpayer requests to use the method of measurement and timing and period-by-period identification provided in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) and Notice 2005-99 is publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2).
- 3) Under the terms of the SBC plan, the service and performance vesting restrictions of the SBC to which this election will apply will not have a substantial effect on the fair value of the SBC under U.S. generally accepted accounting principles ("GAAP") and will not result in unreasonably long vesting periods within the meaning of Financial Accounting Standards Codification Topic No. 718, "Compensation—Stock Based Compensation," Financial Accounting Standards Board (rev. 2016) ("ASC 718").
- 4) For all SBC granted before the first day of the first taxable year following receipt of Service's consent ("Legacy SBC"), Taxpayer and all controlled participants to the CSA will use the method of measurement and timing provided in Treas. Reg. § 1.482-7(d)(3)(iii)(A) and grant date identification provided in Treas. Reg. § 1.482-7(d)(3)(ii) until all Legacy SBC has been exercised or lapsed.
- 5) For all SBC issued with respect to publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2) granted on or after the first day of the first taxable year following receipt of Service's consent, Taxpayer and all controlled participants to the CSA will use the method of measurement and timing provided in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) (and as expanded by Part A of Notice 2005-99).
- 6) For all SBC issued with respect to publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2) granted on or after the first day of the first taxable year following receipt of Service's consent that satisfy the following:
 - a. Are nonvested equity shares or nonvested equity share units within the meaning of ASC 718; and
 - b. Are not subject to market conditions or significant post-vesting restrictions within the meaning of ASC 718,

Taxpayer and all controlled participants to the CSA will use the method of measurement and timing provided in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) (and as expanded by Notice 2005-99).

- 7) If the Commissioner grants consent for Taxpayer to adopt the period-by-period identification method described in Notice 2005-99, and Taxpayer then makes an election to adopt such method, then the Taxpayer additionally represents the following:
1. Taxpayer will apply the identification method consistently as required under the principles of Treas. Reg. § 1.482-7(d)(3)(iii)(C).
 2. Any SBC the fair value of which is not reflected as a charge against income in audited financial statements will be identified for purposes of Treas. Reg. § 1.482-7 as if the fair value of such compensation were reflected as a charge against income in audited financial statements.
 3. As under the grant-date identification rule, under this elective period-by-period identification rule, SBC granted prior to the term of its CSAs will be excluded from the participants' IDCs.
 4. SBC granted, but not vested during the term of the CSA must be treated as vesting immediately before expiration or termination of the CSA for purposes of Treas. Reg. § 1.482-7.
- 8) SBC granted prior to the term of its CSA is excluded from its IDCs.

LAW

Measurement and Timing of SBC Related to Intangible Development

Treas. Reg. § 1.482-7(d)(3)(iii)(A) provides the default method for measurement and timing of SBC IDCs as follows:

Except as otherwise provided in this paragraph (d)(3)(iii), the cost attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an IDC under this section for the taxable year for which the deduction is allowable.

Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) provides the alternative elective method for measurement and timing of SBC IDCs with respect to options on publicly traded stock as follows:

With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a CSA may elect to take into account all IDCs attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

Treas. Reg. § 1.482-7(d)(3)(iii)(B)(4) provides for the time and manner of making the election, in relevant part, as follows:

The election described in this paragraph (d)(3)(iii)(B) is made by an explicit reference to the election in the written contract required by paragraph (k)(1) of this section or in a written amendment to the CSA entered into with the consent of the Commissioner pursuant to paragraph (d)(3)(iii)(C) of this section.

Treas. Reg. § 1.482-7(d)(3)(iii)(C) provides, in relevant part:

[I]f controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(3)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(3)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(3)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

Notice 2005-99¹ extended the elective method to

[N]onvested equity shares or nonvested equity share units within the meaning of Statement of Financial Accounting Standards No. 123, "Share-Based Payment," Financial Accounting Standards Board (rev. 2004) (SFAS 123R), provided that those shares or share units: (i) constitute or are issued with respect to publicly traded stock within the meaning of § 1.482-7(d)(2)(iii)(B)(2); and (ii) are not subject to market conditions or significant post-vesting restrictions within the meaning of SFAS 123R.²

We refer to such shares and share units as "restricted shares and share units." An election to apply the elective method to restricted shares or share units is generally made in the time and manner set forth in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(4).

¹ Notice 2005-99 refers to the SBC rules contained in Treas. Reg. § 1.482-7(d)(2) (2003), the materially similar predecessor of the rules in Treas. Reg. § 1.482-7(d)(3) that are applicable in the present case.

² FAS 123R was amended after the publication of Notice 2005-99 by ASC 718.

However, the consent of the Commissioner is not required to elect the elective method for restricted shares and share units if the election is made by a written amendment to the CSA not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after December 8, 2005.

Identifying SBC Related to Intangible Development

Treas. Reg. § 1.482-7(d)(3)(ii) provides the rule for identification of SBC with the IDA (“grant date identification”), in relevant part, as follows:

The determination of whether stock-based compensation is directly identified with, or reasonably allocable to, the IDA is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the CSA and, at date of grant, is directly identified with, or reasonably allocable to, the IDA is included as an IDC under paragraph (d)(1) of this section.

Notice 2005-99 provides that a taxpayer may choose to determine whether SBC measured by the elective method is related to the IDA by analyzing the activities of the employee recipients of the SBC by reference to financial reporting periods, identifying the related compensation on a period-by-period basis (“period-by-period identification”), rather than using grant date identification. Notice 2005-99 further provides:

Taxpayers’ implementation of this identification method based on financial reporting periods must meet four requirements. First, the identification methodology must be applied consistently (under the principles of § 1.482-7(d)(2)(iii)(C)). Second, any stock-based compensation the fair value of which is not reflected as a charge against income in audited financial statements (for example, as in the case of certain stock options the fair value of which was disclosed in footnotes prior to the effective date of SFAS 123R) must be identified for purposes of § 1.482-7 as if the fair value of such compensation were reflected as a charge against income in audited financial statements. Third, as under the grant-date identification rule, controlled participants using this identification methodology must exclude stock-based compensation granted prior to the term of the QCSA. Fourth and finally, stock-based compensation granted but not vested during the term of the QCSA must be treated as vesting immediately before expiration or termination of the QCSA for purposes of § 1.482-7. Under this final requirement, if costs attributable to stock-based compensation granted during the term of the QCSA are allocable under U.S. GAAP to reporting periods subsequent to the term of the QCSA, the determination of whether these costs must be taken into account as intangible development costs must be based on the employee’s activities as of the financial reporting

period during which the date of the expiration or termination of the QCSA occurs.

Generally, pursuant to Treas. Reg. § 1.482-7(d)(3)(iii)(C) and (B)(4), a change of identification method may be made only by a written amendment to the CSA entered into with the consent of the Commissioner. However, Notice 2005-99 further provides that the consent of the Commissioner is not required to change from grant date identification to period-by-period identification if such written amendment is “made no later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after December 8, 2005.”

In applying period-by-period identification, Notice 2005-99 provides:

[A]ctivities within the intangible development area are not necessarily coextensive with those activities classified as “research and development” for financial reporting purposes. Consequently, nothing in this notice should be interpreted as eliminating the requirement to take into account all stock-based compensation costs related to the intangible development area. Controlled participants must identify the stock-based compensation that is related to the intangible development area, notwithstanding that the activities conducted to develop intangibles covered by the QCSA may differ from the activities classified as “research and development” for U.S. GAAP purposes.

ANALYSIS

Based on the facts and representations Taxpayer has made, the Service grants Taxpayer prospective consent to change to the elective method and period-by-period identification for SBC covered by Treas. Reg. § 1.482-7(d)(3)(iii)(B) and Notice 2005-99. This consent is effective for 60 days from the date of this letter. Therefore, if Taxpayer chooses to adopt the elective method and period-by-period identification, it must make the written elections in its CSA within 60 days from the date of this letter.

The sole purpose of this private letter ruling is to grant consent for Taxpayer to use the elective method and period-by-period identification for purposes of including SBC as an IDC that Taxpayer must share for purposes of its CSA. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter, including the CSA, or concerning the validity of any provisions within the CSA.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Robert Z. Kelley
Senior Counsel, Branch 6
(International)

cc: